

**TENNESSEE DEPARTMENT OF REVENUE  
LETTER RULING # 04-01**

**WARNING**

**Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.**

**SUBJECT**

Whether an LLC and a holding subsidiary are subject to Tennessee franchise and excise taxes.

**SCOPE**

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the Taxpayer. The rulings herein are binding on the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling and a retroactive revocation of the ruling must inure to his detriment.

**FACTS**

[HOLDING SUB] is a business corporation formed under the laws of the State of [NOT TENNESSEE] on [DATE]. The sole shareholder of Holding Sub is the [PARENT], a public pension fund exempt from federal income taxation under 26 U.S.C. § 115 as an instrumentality of the State of [NOT TENNESSEE].

Holding Sub proposes to purchase 100% of the membership interests in [LLC], a limited liability company formed under the laws of the State of Delaware on [DATE], and qualified to do business within the State of Tennessee as of [DATE]. Holding Sub will purchase the membership interest from [SELLER], a Delaware limited partnership and the sole member of the LLC.

LLC's only business is the ownership and leasing of certain improvements located on the real property at [ADDRESS] (the "Improvements"). LLC is, and will continue to be, the lessee of the underlying real property at such address (the "Real Property") under a forty-year ground lease with [LESSOR 1] and [LESSOR 2]. The current term of the ground lease will expire in 2040.

Following the proposed change in ownership, LLC's only business will consist of (1) holding title to the Improvements, (2) leasing and collecting income from the leasing of the Improvements, (3) carrying a third party loan on the Improvements and servicing such debt from the income collected from the leasing of the Improvements, and (4) remitting its entire income (less expenses) to Holding Sub. Thereafter, Holding Sub will remit all funds received from LLC (less Holding Sub's expenses) to Parent. Holding Sub's only business activity, as well as its only contact with the State of Tennessee, will be the ownership of the membership interest in LLC.

Holding Sub intends to seek a determination from the Internal Revenue Service that it is exempt from federal income taxes under 26 U.S.C. § 501(c)(2) as a title holding company. For purposes of this Letter Ruling, the Tennessee Department of Revenue assumes that Holding Sub will be tax-exempt under 26 U.S.C. § 501(c)(2), effective as of its date of formation.

As a single member limited liability company, LLC has elected to be disregarded as a separate entity from Seller (its sole member) for federal income tax purposes pursuant to Treas. Reg. § 301.7701 (2003) (the "check-the-box regulation"). LLC will continue to be disregarded pursuant to such regulations following the proposed ownership change. LLC has not and will not elect to be classified as a corporation under the check-the-box regulations. LLC is currently subject to, and pays, Tennessee franchise and excise taxes.

## **QUESTIONS**

1. Whether LLC will be subject to Tennessee franchise and excise taxes following the acquisition described above?
2. Whether Holding Sub will be subject to Tennessee franchise and excise taxes following the acquisition described above?

## **RULING**

1. No.
2. No.

## ANALYSIS

### Issue 1

Tennessee imposes an excise tax on the net earnings of certain persons doing business within the State. Tenn. Code Ann. § 67-4-2007. Tennessee also imposes a franchise tax on the greater of (1) the net worth of or (2) the value of real and tangible personal property owned or used by persons doing business in Tennessee. Tenn. Code Ann. §§ 67-4-2105, 67-4-2108. Those "persons" subject to the franchise and excise taxes include, but are not limited to, corporations and limited liability companies. Tenn. Code Ann. § 67-4-2004(20). General partnerships and sole proprietorships are not subject to the taxes.

An entity's legal status for state law purposes does not necessarily determine how it will be classified for federal and state tax purposes. The check-the-box regulations set forth the rules for determining how an entity is classified for federal income tax purposes. A single member limited liability company, for example, may elect to be classified as (1) a corporation or (2) as an entity disregarded from its owner. Treas. Reg. § 301.7701-3. Unless the single member limited liability company formally elects to be treated as a corporation, the default rule is that the entity will be disregarded. If the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. Treas. Reg. § 301.7701-2(a).

For purposes of determining an entity's classification for Tennessee franchise and excise tax purposes, Tennessee Code Annotated §§ 67-4-2106(c) and 67-4-2007(d) provide that

a business entity shall be classified as a corporation, partnership, or other type business entity, consistent with the way the entity is classified for federal income tax purposes . . . . Notwithstanding any provision of the law to the contrary, entities that are disregarded for federal income tax purposes, *except for limited liability companies whose single member is a corporation*, shall not be disregarded for Tennessee excise tax purposes. (Emphasis added.)

Thus, a single member limited liability company doing business within Tennessee is disregarded as an entity separate from its sole member for Tennessee franchise and excise tax purposes, in the same manner that it is for federal income tax purposes, provided that (1) the member is a corporation and (2) the limited liability company has not elected to be classified as a corporation under the check-the-box regulations.

As a result of the acquisition described herein, LLC's sole member will be Holding Sub (a corporation). For federal income tax purposes, LLC will continue to be classified as a disregarded entity pursuant to the check-the-box regulations. It will not elect to be classified as a corporation. Thus, for Tennessee franchise and excise tax purposes, LLC will be disregarded as an entity separate from Holding Sub pursuant to Tennessee Code Annotated §§ 67-4-2106(c) and 67-4-2007(d). LLC will not be required to file Tennessee franchise and excise tax returns or separately pay Tennessee franchise and excise taxes.

Rather, the activities of LLC will be attributed to Holding Sub, who, if required to file a Tennessee franchise and excise tax return, would be required to include LLC as a division of Holding Sub in determining any franchise or excise taxes owed. Therefore, the issue is whether Holding Sub is subject to Tennessee franchise and excise taxes as a result of its ownership interest in LLC.

## Issue 2

As a general rule, corporations doing business in Tennessee are subject to Tennessee franchise and excise taxes. There are certain statutory exemptions for such corporations, however, including an exemption for corporations having "not-for-profit" status. Tenn. Code Ann. §§ 67-4-2105(a), 67-4-2007(a).

### Definition of "Not-for-Profit"

For Tennessee franchise and excise tax purposes, the term "not-for-profit" means "any person described in §§ 401, 408, 408A, 409, 501, 526, 527, 528, 529 or 530 of the Internal Revenue Code, as amended from time to time." Tenn. Code Ann. § 67-4-2004(18) (emphasis added). The term "person" includes "every corporation." Tenn. Code Ann. § 67-4-2004(20). Thus, a corporation determined by the Internal Revenue Service to be exempt from federal income taxes pursuant to 26 U.S.C. § 501(c)(2) will fall within the statutory meaning of "not-for-profit" for Tennessee franchise and excise tax purposes. In determining whether Holding Sub satisfies the definition of "not-for-profit," it is worth noting that Tennessee Code Annotated § 67-4-2004(18) does not require that a corporation be organized as not-for-profit under the laws of Tennessee or any other state.

Holding Sub is an [STATE-NOT TENNESSEE] business corporation. Holding Sub plans to obtain from the Internal Revenue Service a determination that it is exempt from federal income taxes pursuant to 26 U.S.C. § 501(c)(2) as a title holding company. Its tax-exempt status will be retroactive to its date of formation. Thus, Holding Sub will be, at all times, a corporation described in Section 501 of the Internal Revenue Code. As a result, Holding Sub will qualify for "not-for-profit" status within the meaning of the term as defined in Tennessee Code Annotated § 67-4-2004(18).

### Exception if "Not-for-Profit" Has Federal Taxable Income

Although an entity satisfies the definition of "not-for-profit," it may, nevertheless, be subject to Tennessee franchise and excise taxes in two situations. First, the not-for-profit exemption will not apply to the extent that the entity has taxable income for federal income tax purposes. Tenn. Code Ann. §§ 67-4-2105(a), 67-4-2007(a). Second, the exemption will not apply if any of the not-for-profit corporation's activities are unrelated to and outside the scope of the activities that give it exempt status. Tenn. Code Ann. §§ 67-4-2105(a), 67-4-2007(a).

As to the first exception, Tennessee Code Annotated § 67-4-2007(a) states that, notwithstanding the general exemption, a person that is not-for-profit will be "subject to excise tax on all its Tennessee net earnings to the extent such earnings constitute

unrelated business taxable income as defined in § 512 of the Internal Revenue Code or are otherwise subject to income taxes under Subtitle A of such code." Tennessee Code Annotated § 67-4-2105(a) is the franchise tax provision that mirrors Tennessee Code Annotated § 67-4-2007(a). Thus, a not-for-profit corporation will be exempt from Tennessee franchise and excise taxes only to the extent that it is not subject to federal income taxes.

Parent has concluded, for reasons explained below, that Holding Sub will not be subject to unrelated business income taxes or any other federal income taxes under the Internal Revenue Code as a result of the activities of Holding Sub or LLC. Because Parent is exempt from federal income taxes under 26 U.S.C. § 115 as an instrumentality of the State of [NOT TENNESSEE], that immunity from taxation extends to Holding Sub, as a wholly owned subsidiary of Parent. Likewise, the immunity also extends to LLC as a disregarded entity and therefore a division of Holding Sub. Accordingly, Holding Sub and LLC are not subject to any federal income taxes under the Internal Revenue Code that otherwise could cause Holding Sub to be subject to Tennessee franchise and excise taxes under Tennessee Code Annotated §§ 67-4-2105(a) and 67-4-2007(a), respectively.

#### Exception if "Not-for-Profit" Engages in Activities Outside the Scope of its Exemption

A corporation that is otherwise exempt as "not-for-profit" will also be subject to Tennessee franchise and excise taxes to the extent that any of its activities are "unrelated to and outside the scope of the activities that give it an exemption status". Tenn. Code Ann. §§ 67-4-2105, 67-4-2007. Neither Holding Sub nor LLC will be engaged in activities that are unrelated to and outside the scope of the activities that give Holding Sub exempt status under the Tennessee franchise and excise tax laws. Holding Sub's exempt status as a not-for-profit entity derives from the fact that it is a corporation described in 26 U.S.C. § 501(c)(2). Section 501(c)(2) includes "[c]orporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under [Section 501]."

Holding Sub is a corporation organized for the exclusive purpose of holding title to 100% of the membership interests in LLC and will remit all funds received from LLC, less Holding Sub's expenses, to Parent. Since LLC is a disregarded entity, its activities will be attributed to Holding Sub. Those activities will consist of (1) holding title to the Improvements, (2) leasing and collecting income from the leasing of the Improvements, (3) carrying a third party loan on the Improvements and servicing such debt from the income collected from the leasing of the Improvements, and (4) remitting its entire income (less expenses) to Holding Sub. The activities of both Holding Sub and LLC fall within the scope of 26 U.S.C. § 501(c)(2). Neither entity will be engaging in activities that are unrelated to and outside the scope of the activities permitted under Section 501(c)(2) and, therefore, unrelated to and outside the scope of the activities that give Holding Sub exempt status under the Tennessee franchise and excise tax laws as a not-for-profit corporation. Thus, Holding Sub will be exempt in every respect from Tennessee franchise and excise taxes.

#### Conclusion

In conclusion, LLC will be disregarded as an entity separate from Holding Sub for Tennessee franchise and excise taxes purposes. Therefore, it will not have to file Tennessee franchise and excise tax returns or pay Tennessee franchise and excise taxes. Instead, LLC will be treated as a division of Holding Sub. Because Holding Sub is a not-for-profit entity within the meaning of Tennessee Code Annotated § 67-4-2004(18), Holding Sub will not have to file Tennessee franchise and excise tax returns or pay Tennessee franchise and excise taxes. The only exceptions would be if Holding Sub (1) were to become subject to federal income taxes as a result of its activities, or (2) were to engage in activities that were unrelated to and outside the scope of the activities that give it exempt status under Tennessee franchise and excise tax laws as a not-for-profit entity. Holding Sub is not currently subject to federal income taxes and does not anticipate becoming subject to such following the acquisition described herein. Moreover, Holding Sub will not engage directly, or indirectly through LLC, in activities that are unrelated to and outside the scope of the activities permitted in 26 U.S.C. § 501(c)(2), which is the basis for Holding Sub's qualification for not-for-profit status and, thus, its exemption under Tennessee franchise and excise tax laws.

Craig A. Jenkins  
Tax Counsel

APPROVED: Loren L. Chumley  
Commissioner of Revenue

DATE: 1/14/04